Volume 55 | Issue 1 Article 4

2010

The Uncorporation's Domain

Larry E. Ribstein

THE UNCORPORATION'S DOMAIN

LARRY E. RIBSTEIN*

I. INTRODUCTION

THE corporation has played a dominant role in business since around the middle of the nineteenth century, at least in the United States. Indeed, laypeople and even most academics use the words "corporate" and "business" interchangeably. In previous writings, however, I have developed a theory and history of business forms showing that the corporation is increasingly competing for dominance with what I call "uncorporate" business forms, including general and limited partnerships and limited liability companies (LLCs).[1] This Article adds a concise description of the current status of the competition, details the business contexts where the uncorporation is now important, and considers changes in current conditions that could affect the uncorporation's role.

It is useful to begin by briefly reviewing the differences between the two types of business associations.[2] One critical difference concerns managerial control of the firm's assets. The corporate form is designed to lock the firm's property rights in the hands of strong managers. Shareholders lack direct access to or control of the firm's property, retaining only indirect power over managers. The corporate governance system seeks to constrain agency costs resulting from delegating power to managers through monitoring devices, particularly including independent directors, shareholder voting, and the shareholders' power to sell their voting rights to purchasers of control. By contrast, the traditional partnership form lets owners cash out of or compel liquidation of the firm. These exit rights effectively give owners joint control over the firm's assets, thereby reducing their need to monitor the firm's managers as compared with the corporate form.

Corporations and partnerships also differ critically regarding flexibility and enforcement of contracts. Partnerships are based fundamentally on the parties' agreement. Uncorporate law has few mandatory rules, and these rules protect the rights of creditors who are not parties to the agree-

---

* Mildred van Voorhis Jones Chair, University of Illinois College of Law. Thanks to participants in the 2009 Villanova Law Review Symposium for helpful comments.

1. *See* LARRY E. RIBSTEIN, THE RISE OF THE UNCORPORATION (2010); Larry E. Ribstein, *Partnership Governance of Large Firms*, 76 U. CHI. L. REV. 289, 290-98 (2009); Larry E. Ribstein, *Why Corporations?*, 1 BERKELEY BUS. L.J. 183 (2004); Larry E. Ribstein, *Uncorporating the Large Firm* 5-20 (Univ. of Ill. Law & Econ. Research Paper No LE08-016, 2008), *available at* http://ssrn.com/abstract=1003790.

2. *See* RIBSTEIN, THE RISE OF THE UNCORPORATION, *supra* note 1, at ch. 1 (describing these differences more fully).

ment. By contrast, the corporate form originated as a creation of government, and the initial corporations were partners in government-created enterprises. When purely private firms started to use the corporate form, they had to effectively buy permission to incorporate from state legislatures. State competition eventually replaced the sale of charters with incorporation for all through general incorporation laws. Vestiges of the corporation's regulatory past remain in the mandatory nature of corporate law compared to the partnership's emphasis on the parties' agreement.

The corporation's rise to dominance resulted at least partly from the need for a durable entity to hold together the larger and more complex businesses that arose during the Industrial Revolution.[3] By the middle of the twentieth century, the corporate form became the dominant choice not only of large firms but also of closely held firms seeking corporate limited liability.[4] Firms' demand for entity features such as durability and limited liability, and firms' inability to obtain them simply through private contracts, enabled state and federal governments to attach tax and regulatory strings to these features. The dominance of the corporate form is at least partly attributable to the government's role in limiting the availability of entity features to this most taxed and regulated business form.

Although corporate features offer significant benefits for modern firms, they also have drawbacks, particularly in their inability to effectively constrain the agency costs resulting from delegating control of the firm's property to the managers.[5] For example, independent directors commonly lack sufficient incentives and information to provide much assurance that managers are doing their jobs. Shareholders of publicly held corporations often either are passive and uninvolved in governance or, like unions or public pension funds, have interests that conflict with those of passive shareholders. Courts are poorly situated to second-guess managers and accordingly apply the business judgment rule, which calls for judicial review only of conflicted or seriously defective decisions.

The uncorporate approach to controlling agency costs accordingly may work better than the corporate approach for some types of firms. Instead of relying on monitors' qualitative review of managerial behavior, uncorporations focus on the outputs of managers' stewardship. Uncorporations distribute profits to owners rather than permanently locking the firm's capital under managers' control. They let owners withdraw cash from the firm without being relegated—as are corporate shareholders—to selling them on the open market at a price discounted by bad management. Uncorporate managers are compensated as true owners rather than as employees. This means that they are not only rewarded for suc-

3. *See* Margaret M. Blair, *Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century*, 51 UCLA L. REV. 387 (2003).

4. *See* RIBSTEIN, THE RISE OF THE UNCORPORATION, *supra* note 1, at chs. 4-5.

5. *See generally id.* at ch. 8; Ribstein, *Partnership Governance of Large Firms*, *supra* note 1, at 290-98 (reviewing costs of corporate governance in publicly held firms).

cess—as are corporate managers through stock options and other incentive compensation—but also penalized for losses. The uncorporate compensation structure also is embedded in the firm's organizational structure and thereby insulated from managerial manipulation.

This Article describes firms' current choice between the corporate and uncorporate governance forms. This choice depends on firms' demand for flexibility, the effectiveness in particular situations of corporate-type monitoring, and the suitability of uncorporate mechanisms of controlling agency costs. This Article suggests that, although the corporation likely will continue to be important for many large firms, uncorporate business forms are likely to become more important for a wide variety of firms. Tax, regulatory, and economic developments will determine the speed but not the existence of the trend.

II. FACTORS DETERMINING CHOICE OF FORM

This Part reviews general considerations bearing on firms' choice between corporate and uncorporate business forms. This analysis helps explain the uncorporation's current domain and provides a basis for projecting future trends.

A. *Private Ordering in Public and Closely Held Firms*

Initially, the corporation was a mechanism for facilitating government control of business and has never completely lost its regulatory nature. For example, corporate statutes are generally phrased in mandatory terms with specific exceptions where the agreement controls, while partnership and other uncorporate statutory provisions generally are subject to contrary agreement except to the extent specified in the statute.[6]

The corporation's regulatory origins cannot fully explain the persistence of corporate law's mandatory approach. Now that firms can choose both their state law and business form, states can compete by offering contractual versions of the corporate form as well as uncorporate statutes. Delaware, for example, has uncorporate statutes that provide for almost complete freedom of contract alongside a corporate statute that provides a more limited version of private ordering.[7] Why have corporate mandatory rules survived in a world of private ordering?

One explanation for the survival of mandatory rules in corporations focuses on the differences between closely and publicly held firms. In publicly held firms, the costs of contracting often may outweigh the benefits. Bargaining over specific terms can be costly in firms with many owners, standardization of terms assists the market in pricing contract terms,

6. *See generally* RIBSTEIN, THE RISE OF THE UNCORPORATION, *supra* note 1.

7. *Compare* DEL. CODE ANN. tit. 8, § 102(b)(7) (2006) (imposing limitations on waiver of corporate fiduciary duties) *with* DEL. CODE ANN. tit. 6, §§ 17-1101, 18-1101 (2009) (providing that fiduciary duties can be "eliminated" by limited partnership and limited liability agreements).

and freedom of contract might give an advantage to powerful managers and majority shareholders.[8] Investors therefore would prefer to simply shop for firms that have the terms they want rather than preserving their freedom to bargain over these terms. The shareholders also in effect delegate to state lawmakers the power to modify their contracts by amending the corporate statute rather than having to initiate changes or monitor changes made by managers.[9] In closely held firms, on the other hand, contracting costs are lower and the benefits of private ordering are more likely to exceed the costs.

Because this explanation for the survival of corporate mandatory rules focuses on differences between publicly and closely held firms, it does not explain either the closely held corporation or the publicly traded partnership. As discussed below, the close corporation can be accounted for as the product of tax and regulation, while the publicly traded partnership results from advantages of the uncorporation other than its flexibility.

B. *Benefits of Uncorporate Governance*

Uncorporations control agency costs in part by reducing managers' control over the firm's cash. Unlike corporate managers, uncorporation managers cannot rely on a permanent cache of equity capital to fund their ventures. Their need to keep seeking funding ensures that their activities will be continually monitored by the capital markets. This reduces uncorporations' need to rely on corporate-type monitoring of managers' performance through such devices as independent directors, voting by passive or conflicted shareholders, and fiduciary duty litigation.

Uncorporate governance does not, however, work equally well with all types of firms. The same features of large firms that led them to choose the corporate form over the partnership during the Industrial Revolution still influence choice of form today. Lack of permanent capital may be unsuitable for growing firms that need to lock assets under managers' control for an indefinite period to give them an opportunity to carry out their business plans.[10] This uncorporate device is better suited to mature, low-growth firms, which can set specific financial targets and time-frames. Also, uncorporations' limited life and distribution obligations may force piecemeal liquidation of assets, which can be especially costly for firms with "firm-specific" assets—that is, assets whose value depends significantly on being used in a particular business.[11]

The suitability of uncorporate governance in particular situations may depend on the costs of corporate governance. For example, the boom in

8. *See* Henry Hansmann, *Corporation and Contract*, 8 AM. L. & ECON. REV. 1, 1-7 (2006).

9. *See id.* at 9.

10. *See* Blair, *supra* note 3, at 391-92.

11. *See* Chris Parsons & Sheridan Titman, *Capital Structure and Corporate Strategy* (2007), *available at* http://ssrn.com/abstract=983553.

financial derivatives created business risks buried in complex financial models that were especially difficult for non-finance-trained executives to understand. Credit rating agencies, passive shareholders, independent directors, and others failed to spot the vulnerability of derivatives increasingly based on subprime assets to a fall in real estate prices. The fact that financial corporations crashed while unincorporated hedge funds generally avoided betting their firms on questionable valuation models arguably reflects the different managerial incentives in the two types of firms. As discussed below in Part VI.B., this may support the use of uncorporate structures in investment banking firms despite these firms' reliance on corporate-type permanent financing.

Although uncorporate governance may be inappropriate for *operating* some types of firms, such as those needing corporate-type durability, it may be appropriate for the *owners* of these firms. As discussed below in Part VI, this includes venture capital, private equity, and hedge funds. The risks of large, undiversified investments and the constraints imposed by uncorporate governance may, however, limit holding periods, and therefore force shareholders organized as uncorporations to focus on relatively short-term strategies in their portfolio firms, particularly including quick restructuring or public offerings.

C. *Limited Liability*

So far this Part has discussed costs and benefits that arise inherently from firms' structure. Government also may add constraints that need to be taken into account in choice of form.

Until recently, protecting owners from personal liability for their firms' debts was a major consideration driving choice of form. State lawmakers effectively channeled firms into the corporate form by restricting uncorporations' ability to contract for limited liability.[12] Federal tax law assisted the states by using limited liability as an important "corporate" characteristic for purposes of classifying firms for tax purposes, thereby forcing firms to choose between limiting owners' personal liability and avoiding the corporate tax.[13] Over the last twenty years, however, state statutes, spurred by changes in the tax advantages of incorporation, swept away barriers to limited liability for closely held uncorporations, including the tax classification rule as discussed in Part II.D. below.[14] This has resulted in the rapid rise of the LLC as a challenger to the close corporation.

Although the legal barriers to uncorporate limited liability are gone, transaction cost concerns remain. As discussed above, uncorporations rely

12. *See* RIBSTEIN, THE RISE OF THE UNCORPORATION, *supra* note 1, at ch. 4.

13. The former tax classification rule, now superseded by the "check the box" rule discussed *infra* in note 15, is Treas. Reg. § 301.7701–2(a) (1996). For a discussion of tax classification and its effect on choice of form, see RIBSTEIN, THE RISE OF THE UNCORPORATION, *supra* note 1, § 5.D.

14. *See* RIBSTEIN, THE RISE OF THE UNCORPORATION, *supra* note 1, at ch. 6.

on owner access to the firm's cash to control potential abuse by managers or controlling shareholders. This access becomes even more important when tax considerations are factored in. Applying the single level partnership tax motivates owners to have the firm distribute its earnings rather than force partners to pay tax on money that remains locked in the firm. Yet distributing the firm's cash to the owners leaves less for creditors. Firms must balance the benefits to owners of combining limited liability and uncorporate features against their potentially increased cost of credit when they combine these elements. Moreover, courts and legislators may be concerned that limited liability will enable firms to impose costs on tort creditors who are not in a position to bargain over credit terms.

D. *The Corporate Tax*

The tax classification rules initially imposed costs on firms that chose to adopt certain "corporate" features, such as limited liability and insulation from dissolution upon owner dissociation. Following the developments referred to in the previous section, the United States Treasury adopted a rule letting closely held firms "check a box" whether they wanted to be taxed as corporations or partnerships.[15] Thus, for closely held firms, tax classification was no longer a choice-of-form consideration. The key remaining rule classifying firms for tax purposes imposes the corporate tax on most firms that have publicly tradable shares.[16]

Though current tax rules do not bar firms from adopting any type of business form, they do constrain choice of form. As discussed above, a key feature of the uncorporate form is the discipline placed on managers by the owners' access to the cash. This discipline is crimped to the extent that a firm's distributions are discouraged by applying a second-level tax on top of the one imposed on the firm's income. Thus, while even publicly held firms subject to the corporate tax can be partnerships, they have less incentive to adopt uncorporate forms if they are subject to the corporate tax.

III. THE RISE OF THE UNCORPORATION

Part II presented a static analysis of firms' choice between corporate and uncorporate forms. There is a dynamic element to the story as well—the *rise* of the uncorporation and consequent reduced dominance of the corporate form. These developments have been driven by several factors detailed in the following subsections.

---

15. *See* Treas. Reg. § 301.7701-1 to -3 (2009).

16. *See* I.R.C. § 7704 (2008).

A. *Tax Changes*

The Reagan tax revolution, which reduced the top personal tax bracket from 70% to 28%,[17] made the double corporate tax on both corporate earnings and distributions to shareholders increasingly burdensome for many firms by eliminating the advantage of sheltering corporate income in the corporation rather than distributing it to shareholders. This motivated firms to seek partnership forms of business that were subject to single-level partnership taxation while at the same time having the key corporate feature of limited liability. The ultimate result was new uncorporate business association statutes and the change in the tax classification rules discussed above.

Future tax changes could have an equally important impact on the uncorporation's role in larger firms. The category of publicly held uncorporations has been limited by the narrow federal tax definition of the publicly traded firms that are eligible for partnership tax treatment.[18] In other situations, particularly including hedge, private equity, and venture capital, firms get many of the advantages of partnership tax treatment by using debt, which mitigates double corporate taxation by allowing firms to deduct interest payments. Without this tax constraint, firms could use uncorporate contracts to replicate the incentive effects of debt, such as contracts promising regular cash payments and providing for a time limit on the firm's use of investors' capital, while reducing the risk of costly bankruptcy. Changing tax law to enable broader use of publicly traded partnerships therefore could significantly affect firms' choice between the corporate and uncorporate forms.

B. *Innovation*

The development of new governance technologies has played an important role in the rise of the uncorporation. Perhaps the most important innovation was the LLC, which, as discussed in Part II.C. above, has been so significant in undermining the corporation's dominance in closely held firms. The innovations in private equity financing by such entrepreneurs as Henry Kravis of Kohlberg Kravis Roberts & Co. and Stephen Schwarzman of The Blackstone Group, are also well known.[19]

The role played by specific innovations is, however, difficult to isolate for several reasons. First, technological development has been incremental. The uncorporation's rise has not been marked by great leaps forward comparable to the incandescent light bulb or, for that matter, the poison

17. *See* Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (reducing top rate to 28%); Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172 (reducing top marginal income tax rate from 70% to 50%).

18. *See infra* note 38 and accompanying text.

19. For a history of the development of private equity, see GEORGE P. BAKER & GEORGE DAVID SMITH, THE NEW FINANCIAL CAPITALISTS (1998); Allen Kaufman & Ernest J. Englander, *Kohlberg Kravis Roberts & Co. and the Restructuring of American Capitalism*, 67 BUS. HISTORY REV. 52 (1993).

pill. Each new device had to be tested, applied, and shaped through agreements and litigation.

Second, it is not clear whether governance innovations are causes or effects of business, tax, and regulatory conditions. For example, private equity developed against the background of the market for corporate control. As takeover defenses became more sophisticated, takeover technologies evolved to keep pace. Thus, private equity arguably developed in response to other law as well as promoting change in the law.

Third, innovations' role in the development of the uncorporation is intricately related to the forces operating in the market for law discussed in section III.C. below. In particular, the limited partnerships and LLCs that have been used to organize publicly traded partnerships and private equity, hedge, and venture capital funds could not have served these purposes effectively unless Delaware and other courts and legislatures had competed in the law market with flexible statutory rules and sophisticated case law.[20]

C. *Market for Law*

An important aspect of the decline of corporate dominance is the pressure on mandatory business association rules created by markets for law and contracts. To the extent that the corporation's dominance can be attributed to tax and regulatory rules, these rules are subject to erosion as private actors seek competitive advantage through greater flexibility. Lawyers, state legislatures, and judges responded to the increased demand for the uncorporation by creating new entity forms, particularly including the LLC and a modern version of the limited partnership, both of which enabled firms to combine partnership flexibility with limited liability. These developments were promoted by vigorous state competition powered by application to uncorporations of the corporate "internal affairs" choice of law rule which enabled firms to choose the state law applicable to their governance irrespective of where they did business.[21] This state competition eventually affected even the federal tax by eroding the state statutory basis for the federal government's classification of corporations and partnerships for tax purposes.[22]

---

20. *See* DEL. CODE ANN. tit. 6, §§ 17-1101, 18-1101, tit. 8, § 102(b)(7) (2007).

21. *See* RESTATEMENT (SECOND) OF CONFLICT OF LAWS §§ 304, 307 (1971) (providing for corporate choice of law rule). For discussions of this rule and its role in the jurisdictional competition for corporate and uncorporate business forms, see ERIN ANN O'HARA AND LARRY E. RIBSTEIN, THE LAW MARKET 107-31 (2009); Erin Ann O'Hara & Larry E. Ribstein, *Corporations and the Market for Law*, 2008 ILL. L. REV. 661, 661-67 (2008). For evidence of a jurisdictional competition for LLC formations, see Bruce H. Kobayashi & Larry E. Ribstein, *Jurisdictional Competition for Limited Liability Companies*, 2010 U. ILL. L. REV. (forthcoming).

22. For a discussion of state competition's effect on federal tax see *supra* Parts II.C. and D.

D. *The Demand for Capital Lock-In*

The rise of the corporation has been attributed to its ability to lock in capital, thereby enabling managers to engage in long-term business planning.[23] The need for capital lock-in depends on the particular firm and general business conditions. In some firms, the benefits of capital lock-in may outweigh its costs in terms of reducing capital market discipline of managerial conduct. The benefits of capital lock-in generally have been declining with firms' ability to outsource their needs from a large international market of independent suppliers.[24]

E. *Regulation*

Regulation of corporate governance may increase the demand for uncorporate alternatives. There is evidence connecting the growth of private equity with firms' costs of complying with the Sarbanes-Oxley Act.[25] While escape from regulation can trigger political demands to close the loophole, the inherent flexibility of the uncorporation and state competition for business forms enables firms to find ways around regulation. The development of new business forms, in turn, increases the difficulty of imposing future regulation. Thus, the uncorporation, which provides a flexible alternative to the corporation, is not just a response to particular regulation, but an inherent constraint on regulating firms' governance.

IV. CLOSELY HELD FIRMS: THE DISAPPEARING CLOSE CORPORATION

Although the corporation was designed for large publicly held firms, by the mid-twentieth century it had dominated closely held firms as well. This seems strange because the partnership is clearly more suitable than the corporate form for closely held firms. Partnership default rules are designed for firms with a few owners who share management and profits, in contrast to the separation of ownership and control that characterizes corporations.[26] Moreover, the corporate feature locking control of assets in strong managers, which is so valuable for publicly traded firms, can present problems when no public market exists to provide owners with a potential escape from oppressive managers and majority owners. The rise of the close corporation therefore seems entirely attributable to tax and regulatory constraints on the availability of the partnership.

To be sure, the corporate form has potential advantages for closely held firms. In particular, partnership default rules enabling owners to cash out of or force liquidation of the firm can invite opportunistic con-

23. *See supra* note 3 and accompanying text.

24. *See* RIBSTEIN, THE RISE OF THE UNCORPORATION, *supra* note 1, § 8.E.1.

25. *See* COMM. ON CAPITAL MARKETS REGULATION, INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION (2006), *available at* http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf.

26. *See generally* RIBSTEIN, THE RISE OF THE UNCORPORATION, *supra* note 1, at ch. 3.

duct by individual members and possible loss of going concern value.[27] The owners of closely held firms also may want corporate-style limited liability and to delegate control to managers.

Although corporate default rules can be valuable for some types of closely held firms, the flexibility discussed in Part I is the decisive consideration regarding the uncorporation's suitability for closely held firms. The uncorporation's emphasis on the parties' agreement enables closely held firms to contract for precisely the mix of lock-in and exit and centralization of management they prefer. At the same time, uncorporate default rules suit the smallest firms for which the costs of making customized contracting are likely to be the most burdensome. Indeed, much of the case and statutory law of close corporations concerns problems of protecting unwary owners who have been locked-in by corporate default rules and oppressed by majority owners.[28]

Closely held firms' choice of the corporate form is not, then, readily explained by the corporation's innate suitability for this type of firm. Rather, the rise of the close corporation is perhaps best explained by firms' demand for limited liability.

To be sure, limited liability is not necessarily advantageous for closely held firms. Firms generally must pay their creditors to take the extra risks of forgoing the ability to collect debts from firms' owners, particularly including the risk that owners will disregard creditors' interests in running the firm. Publicly held firms usually find it worth incurring these extra costs because of the substantial benefits of public tradability of the firm's shares, which would be impractical if liability for debts attaches to the shares.[29] In contrast, closely held firms may find that the extra credit costs under limited liability outweigh any cost savings.

The cost-benefit tradeoff with respect to limited liability, however, changed for closely held firms with the rise of tort and regulatory liability in the twentieth century. By the middle of the twentieth century, vicarious liability had become very risky for owners of all firms. Moreover, much of the increased liability was to creditors who were not in a position to adjust their credit costs for the extra risk. Since initially firms had to incorporate to get limited liability, increased liability risk made both large and small firms want to incorporate.

27. *See* Larry E. Ribstein, *A Statutory Approach to Partner Dissociation*, 65 WASH. U. L.Q. 357, 364-76 (1987) (analyzing costs and benefits of default rules facilitating owner exit from closely held firms).

28. This history is reviewed in RIBSTEIN, THE RISE OF THE UNCORPORATION, *supra* note 1, § 5.H.4.

29. *See* Susan Woodward, *Limited Liability in the Theory of the Firm*, 141 J. INSTITUTIONAL & THEORETICAL ECON. 601, 602-06 (1985). This assumes owners have joint and several liability for the firm's debts. Tradability may not be inconsistent with pro rata liability. *See* Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879 (1991). Joint and several liability, however, was the partnership rule that would have applied to mid-twentieth-century firms that did not incorporate.

The question at this point is why firms had to accept unsuitable corporate default rules as the price of limited liability. There are both policy and political explanations for why states initially did not offer statutes providing for partnerships with limited liability. From a policy standpoint, limited liability presents special dangers in partnerships because the partnership's impermanence and partners' access to the firm's cash increase the risks of creditors who rely on the entity's assets for payment of their debts. From a political standpoint, state legislators had an incentive to confine limited liability to a regulated form of business whose terms they could control, rather than making it available to the contract-based partnership form.

Although state legislators collectively had an incentive to restrict limited liability to the corporate form, individual states wanted to attract business formations from other states by developing business forms that enabled firms to combine the partnership with limited liability. This illustrates how a federal system offers opportunities for innovation. The problem is that a federal system also can squelch innovation. No single state could hope to successfully innovate unless courts and legislatures in other states were willing to enforce the innovation. Although corporate rules were governed by the incorporating state's law, this choice of law rule did not, at least initially, apply to unincorporated firms. Thus, a firm forming a limited liability partnership under a particular state's law could not be sure that that state's law would apply in any other state in which the firm transacted business.

The corporate tax additionally complicates choice of form. Federal tax rules treated firms with limited liability as corporations even if they were partnerships under state law.[30] Thus, if a firm wanted partnership characteristics, particularly including the absence of corporate-type capital lock-in, it would face double taxation on both income at the firm level and distributions to partners at the owner level.

State and federal law also tried to make the corporate form more palatable to closely held firms. States increasingly allowed closely held firms to contractually vary formerly mandatory corporate rules and developed procedures enabling exit of minority owners to escape minority oppression.[31] Federal tax law was changed to permit closely held firms to form "Subchapter S" corporations that were taxed like partnerships.[32] These federal and state rules enabled closely held firms to adopt limited liability while being governed by partnership-type internal and tax rules.

Yet these rules offered an imperfect compromise. They could not solve the underlying problem of the unsuitability of state and federal corporate rules for closely held firms. Even if closely held corporations could

30. For a discussion of the impact of federal tax rules, see *supra* Section II.C.

31. *See generally* RIBSTEIN, THE RISE OF THE UNCORPORATION, *supra* note 1, § 5.H.

32. *See* I.R.C. §§ 1361–1379 (2007).

waive corporate default rules, they would still be subject to these rules whenever there were gaps in their contracts. Subchapter S was available only to closely firms that were willing to adopt the simplest capital structure of one class of stock.[33] This inhibited firms from taking full advantage of uncorporate flexibility. Nevertheless, the availability of Subchapter S was just enough to keep closely held firms from experimenting with purer forms of limited liability partnerships, and thereby challenging both state law constraints on limited liability and federal tax classification rules.

This equilibrium changed with the 1980s tax revolution, which sharply reduced the tax advantage of incorporation and thereby encouraged firms and states to experiment with limited liability partnerships.[34] At this point one might expect the corporate form to disappear for closely held firms. After all, the above history suggests that the close corporation was simply a makeshift structure intended to navigate state and federal restrictions on limited liability partnerships. The disappearance of these restrictions seemingly eliminated the close corporation's *raison d'etre.* Yet many closely held firms continue to incorporate. What explains this puzzling persistence?

One explanation for the close corporation's survival may be that the large body of close corporation law provides more predictability than is available for the relatively new partnership-type forms. The corporation's edge could be expected to diminish as more firms choose the new business forms, develop form agreements, and generate cases deciding the open questions. If the uncertainties inherent in the new forms and the hesitance of firms' advisors to learn about them deter firms from abandoning the corporate form, however, the cases will not be decided and the uncertainty will continue.[35]

It is unlikely that this "chicken-and-egg" situation will impede a move over the long run to more efficient business forms. This conclusion is supported by evidence that firms generally rejected a business form, the "limited liability partnership," that was specifically designed to minimize predictability problems by simply adding limited liability to the partnership standard form.[36] Firms embraced the LLC—a brand new form that provided rules more appropriate for closely held limited liability firms, but coupled with the uncertainty inherent in innovation. On the other hand, although firms evidently are selecting the LLC over the partnership standard form, it is less clear that they are abandoning the close corporation.

---

33. *Id.* § 1361(b)(1)(d).

34. *See supra* note 17 and accompanying text.

35. In other words, individual parties lack incentives to form new types of partnerships even if this choice might generate social benefits in developing superior standard forms. *See* Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 772-822 (1995).

36. *See* Bruce H. Kobayashi & Larry E. Ribstein, *Choice of Form and Network Externalities*, 43 WM. & MARY L. REV. 79 (2001).

Thus, although it seems likely the close corporation will disappear over time, the jury is still out on this question.

V. THE PUBLICLY HELD UNCORPORATION

Some large, publicly traded firms are organized as uncorporations, or "publicly traded partnerships" (PTPs). These firms generally invest in assets such as natural resources and pipelines that produce reliable earnings and do not require active management. Such firms can commit to the standard uncorporate devices of investor access to the cash through regular distributions and mandatory liquidation without compromising long-term business plans. Thus, PTP agreements traditionally promise to distribute net cash less reserves, restrict actions such as issuance of additional equity that might reduce distributions, and link general partners' compensation to distributions to the limited partners. At the same time, the agreements eliminate or minimize corporate-type monitoring by providing for limited voting rights, opting out of fiduciary duties, and imposing barriers to hostile takeovers.[37]

Tax constraints currently narrow the publicly traded partnership's domain to the most passively-managed rent collectors. The Internal Revenue Code provides that publicly traded firms can be organized as tax partnerships only if they mostly earn "qualifying income," which the Code defines as such things as interest, dividends, rents, and capital gains.[38] Although all publicly held firms are free to choose the partnership form, they have little reason to do so if the tax laws effectively penalize uncorporate-type reliance on distributions by imposing an extra tax on these distributions.

VI. THE UNCORPORATION AS SHAREHOLDER

The demand for uncorporate governance in large firms extends beyond the narrow domain of publicly traded partnerships. In these situations, the uncorporation plays a role as the governance form of the owners of various types of firms. Uncorporate governance contributes to these firms' incentive to maximize the value of their portfolio firms. This Part discusses the most prominent examples.[39]

37. *See generally* John Goodgame, *Master Limited Partnership Governance*, 60 BUS. LAW. 471 (2005) (analyzing agreements in publicly traded partnerships).

38. *See* I.R.C. § 7704(c)-(d) (2008). The Code also permits the analogous structure of Real Estate Investment Trusts (REITs), which receive flow-through partnership type tax treatment if they get most of their income from real estate—again, classic rent collection—and distribute most of this income to investors. *See* I.R.C. §§ 856-857 (2008).

39. For further discussion of uncorporate governance in large firms, see RIBSTEIN, THE RISE OF THE UNCORPORATION, *supra* note 1, at ch. 8; Ribstein, *Partnership Governance of Large Firms*, *supra* note 1, at 289-98; Ribstein, *Uncorporating the Large Firm*, *supra* note 1, at 5-20.

A. *Start-Ups: Venture Capital*

Venture capital (VC) backed start-up firms generally organize as corporations. The reasons for this choice of form are complex.[40] For present purposes it is enough to show that the roles of corporations and uncorporations in this setting are generally consistent with this Article's observations about the uncorporation's domain.

First, it is important to keep in mind that VC-backed firms traditionally have been designed for an eventual public offering, which is the conventional exit route of the venture capital investors.[41] Also, as early-stage firms, these companies typically are growing and still developing their business plans. They would therefore be poor candidates for uncorporate-type distribution requirements, investor cash-out, and limited life.

Second, while these firms adopt the corporate form, they still have significant uncorporate features. Perhaps most importantly, VC investors rely significantly on exit rights rather than monitoring. For example, investors make staged investments, where they retain the right to not make later contributions.[42] They also traditionally have invested through preferred shares that provide for rights to compel liquidation, redemption, or public offering of their shares,[43] and have used debt financing in part to discipline managers by giving investors access to the cash.[44]

Third, uncorporate owners of VC corporations hold the critical governance levers. The owners are funds organized as limited partnerships that specialize in start-up firms.[45] These funds traditionally have been governed by agreements that provide for high-powered compensation of the VC general partners,[46] as well as investor exit rights through staged invest-

---

40. *See* Joseph Bankman, *The Structure of Silicon Valley Start-Ups*, 41 UCLA L. REV. 1737, 1755-66 (1994) (offering behavioral explanation for why VC investors appear to ignore tax benefits of flow-through losses in partnership form in favor of expected gains); Victor Fleischer, *The Rational Exuberance of Structuring Venture Capital Start-Ups*, 57 TAX. L. REV. 137, 151-53 (2004) (proposing both tax and non-tax considerations, particularly relating to complex tax implications for tax-exempt investors in venture capital funds).

41. *See* Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1075 (2003).

42. *See id.* at 1078.

43. *See* Philippe Aghion et al., *Exit Options in Corporate Finance: Liquidity Versus Incentives*, 8 REV. FIN. 327 (2004); Douglas J. Cumming & Jeffrey G. MacIntosh, *Venture-Capital Exits in Canada and the United States*, 53 U. TORONTO L.J. 101, 118-20 (2003); D. Gordon Smith, *The Exit Structure of Venture Capital*, 53 UCLA L. REV. 315, 345-56 (2005).

44. *See* Darian M. Ibrahim, *Debt as Venture Capital*, 2010 U. ILL. L. REV. (forthcoming) (discussing staged financing and explaining debt financing by venture capital firms as mechanism for controlling agency costs by reducing managers' control over cash).

45. *See* PAUL GOMPERS & JOSH LERNER, THE VENTURE CAPITAL CYCLE 8-11 (1999) (discussing limited partnership structure of venture capital investments).

46. *See* Andrew Metrick & Ayako Yasuda, *The Economics of Private Equity Funds* 10–14 (Swedish Inst. for Fin. Research Conference on Econ. of the Private Equity

ments.[47] There is evidence that these exit rights function as a substitute for corporate-type monitoring rights.[48]

B. *Private Equity*

An important use of the uncorporation in managing large firms has been through private equity partnerships. As with venture capital, the portfolio firms are usually corporations, but buyout funds organized as limited partnerships hold the governance levers. These funds' uncorporate features include high-powered managing partner incentive compensation, investor access to the cash through liquidation after a fixed term, and assurance of regular distributions.[49] At the portfolio firm level, substantial debt serves the same role as the uncorporate structure in giving the investors (in this case, creditors) access to the firm's cash. Tax considerations help explain this substitution of debt for uncorporate equity.[50]

C. *Hedge Funds*

Hedge funds, as indicated by their name, traditionally seek to take advantage of temporary market disequilibria by purchasing economically equivalent instruments whose values are out of sync. So-called "activist" hedge funds extend this model by investing in corporations with a view to pushing them to restructure. The funds thereby hope to cash in on the difference between the value of assets under current management and their value if sold or managed differently.[51]

Hedge funds' uncorporate structure (again, typically limited partnership) motivates managers to secure above-market gains. The structure traditionally has included high-powered compensation of fifteen to twenty percent profit share above a specified hurdle rate, restricting managers' control over the cash by providing for distributions and termination, and investors' rights to cash out after an initial lock-up period.[52] These devices

---

Mkt., 2008), *available at* http://ssrn.com/abstract=996334 (discussing compensation in VC funds).

47. *See* Kate Litvak, *Firm Governance as a Determinant of Capital Lock-in* 6–7 (Univ. of Tex. Law and Econ. Research Paper No. 95, 2007), *available at* http://ssrn.com/abstract=915004.

48. *See id.* (showing that stronger investor "walkaway" rights are associated with less reliance on governance devices such as boards).

49. *See* Ulf Axelson et al., *Why are Buyouts Levered? The Financial Structure of Private Equity Funds*, 64 J. FIN. 1549 (2009).

50. For a discussion of the impact of tax considerations, see *supra* Parts II.C-D.

51. For data on hedge funds' success in creating value, see Alon Brav et al., *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729, 1736-49 (2008); Robin Greenwood & Michael Schor, *Investor Activism and Takeovers*, 92 J. FIN. ECON. 362, 363-68 (2009); April Klein & Emanuel Zur, *Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors*, 64 J. FIN. 187, 196 (2009).

52. For a comprehensive analysis of hedge fund governance mechanisms, see Houman B. Shadab, *The Law and Economics of Hedge Funds: Financial Innovation and Investor Protection*, 6 BERK. BUS. L.J. (forthcoming 2009), *available at* http://papers.

substitute for corporate-type monitoring devices such as independent directors, fiduciary duties, and takeovers.[53]

Hedge funds should be contrasted with mutual funds. Hedge funds are not subject to the tax and regulatory requirements that require mutual funds to diversify their holdings, preventing them from being used for taking large and active positions in portfolio firms.[54] Hedge fund managers are not subject to the Investment Advisers Act's limits on management fees.[55] Hedge funds also differ from private equity funds in typically operating for a shorter term, and therefore focusing on the kinds of gains that can be made from relatively quick asset restructuring.[56]

Hedge funds can be adapted to all kinds of market conditions. For example, some hedge funds have specialized in investments known as "PIPEs," or "Private Investments in Public Equity," in which firms invest in

ssrn.com/sol3/papers.cfm?abstract_id=1066808. For analyses of hedge fund governance focusing on their incentive compensation structures, see Robert C. Illig, *The Promise of Hedge Fund Governance: How Incentive Compensation Can Enhance Institutional Investor Monitoring*, 60 ALA. L. REV. 41, 58-98 (2008) [hereinafter Illig, *The Promise of Hedge Fund Governance*]; Robert C. Illig, *What Hedge Funds Can Teach Corporate America: A Roadmap for Achieving Institutional Investor Oversight*, 57 AM. U.L. REV. 225, 315-35 (2007).

53. *See* Illig, *The Promise of Hedge Fund Governance*, *supra* note 52, at 58-78; M. Corey Goldman, *Mutiny? Good Luck*, ALPHA (Feb. 24, 2009), http://www.iimagazine.com/Alpha/Articles/2113458/FEATURES/Mutiny?_Good_Luck.html (noting investors' difficulty in some hedge funds of calling meetings and fact that management may hold majority of voting power).

54. *See generally* Mark J. Roe, *Political Elements in the Creation of a Mutual Fund Industry*, 139 U. PA. L. REV. 1469 (1991).

55. *See* Investment Advisers Act of 1940, 17 C.F.R. § 275.205-3 (2009) (exempting advisors to hedge and private equity funds from limitations on performance fees).

56. *See* Greenwood & Schor, *supra* note 51, at 368-72 (showing evidence indicating that hedge funds are better suited for identifying undervalued targets and prompting takeovers than for improving long-term governance or operation).

financially distressed publicly held firms.[57] This may include participation in the federal government's troubled asset program.[58]

D. *The Uncorporation in the Market for Corporate Control*

Although the discussion so far in this Part suggested that a broad range of firms are susceptible to uncorporate governance, this leaves many publicly held firms that are currently not candidates for hedge fund or private equity restructuring and are outside the limited PTP range. Uncorporate governance nevertheless can play a role by waiting in the wings, prepared to move in through an uncorporate-engineered restructuring when a firm's agency costs become high enough to justify the costs of restructuring. Indeed, private equity and hedge funds have evolved to play a major role in the market for corporate control. The uncorporation therefore can be viewed as part of the *corporation*'s day-to-day monitoring structure. The extent of the uncorporate role will depend on balancing the net benefits of corporate-type monitoring against those of uncorporate-type capital market discipline on a firm-by-firm basis.

VII. EXTENDING THE PUBLICLY TRADED PARTNERSHIP

The uncorporation potentially could move into a more important role in providing the governance structure for large firms themselves rather than just for their owners. As discussed in Part III.A., publicly traded partnerships are constrained by restrictions on partnership taxation of publicly traded firms. More firms might adopt the structure if tax restrictions were relaxed.

A potential concern with publicly held uncorporations is that their departure from the standardized corporate model might confuse investors, particularly in smaller firms that trade in relatively inefficient markets. As discussed above, this concern with information costs and standardization helps explain publicly held firms' use of the corporate

57. For descriptions and analyses of PIPEs, see Susan J. Chaplinsky, *PIPES: Private Equity Investments In Distressed Firms* (July 2003), http://ssrn.com/abstract=909741; Hsuan-Chi Chen et al., *The Choice of Equity Selling Mechanisms: PIPEs versus SEOs* (May 2008), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1139887; Jeffrey Marell & Tracey Zaccone, *PIPEs: Raising Equity Capital in Uncertain Times*, June 3, 2009, http://blogs.law.harvard.edu/corpgov/2009/06/03/pipes-raising-equity-capital-in-uncertain-times/ (noting participation of seasoned issuers and mainstream hedge and private equity funds in PIPEs market); William K. Sjostrom, Jr., *Pipes*, 2 ENTREPRENEURIAL BUS. L.J. 381, 381-414 (2007). Some venture capital funds have also been making these investments. *See* Pui-Wing Tam, *Venture Capitalists Chart a New Course*, WALL ST. J., Mar. 13, 2009, at C1. Hedge funds also may invest in distressed debt, which effectively becomes equity in insolvent or bankrupt firms. *See* Mike Spector & Jeffrey McCracken, *Barbarians in Bankruptcy Court: Merger Financiers Find Action Now in Chapter 11; 'Debt Is the New Equity'*, WALL ST. J., June 19, 2009, at C1 (discussing participation of private equity firms and banks in bankruptcy "363" restructurings).

58. *See* Jenny Strasburg, *Hedge Funds' TALF Tack Is One of Interest, Caution*, WALL ST. J., Mar. 13, 2009, at C1.

form. One way to address this would be to establish quasi-public markets in uncorporate shares open only to institutional and other large investors along the lines of the PORTAL market created in 2007.[59] The following are some scenarios in which publicly traded uncorporations might expand their role.

A. *Restructuring*

Private equity financing can be seen as a temporary structure designed to deal with current tax limits on publicly traded partnerships discussed in the previous section. Private equity in effect substitutes debt for the uncorporate incentives and discipline of publicly traded partnerships. If publicly held firms could elect to be treated as tax partnerships, some firms currently operating as debt-financed private equity portfolio firms might take on permanent financing by selling publicly traded partnership interests. Indeed, some private equity management firms did do so at the height of the financing boom in 2007 and 2008.[60] The ability to make liquid investments as part of a diversified portfolio would mitigate investors' risk, facilitating investments for longer terms than is currently feasible. The firms' governance would entail some of the discipline of debt, particularly including owner access to the cash through regular payments and a right to cash out, but with less risk of costly bankruptcy than in a highly leveraged corporation if cash flows fall short of expectations. Although public ownership would trigger application of the securities laws, there is evidence that this increased regulatory risk has not deterred publicly traded *debt* interests in some "private" equity financing.[61] This reinforces the likelihood that tax rather than regulatory considerations are the important constraint on publicly traded partnership-type firms.

Additional firms that might be expected to take advantage of abolition of the tax constraint on publicly traded partnerships include actively managed firms that produce regular earnings, as by capitalizing on established brands, and that could be liquidated without disrupting ongoing business plans. These business features mesh with uncorporate contractual provisions for regular distributions and liquidation.

---

59. *See* Press Release, NASDAQ, Inc., The PORTAL Alliance to Create Industry-Standard Facility for 144A Equity Securities (Nov. 12, 2007), http://ir.nasdaq.com/releasedetail.cfm?ReleaseID=275224; *see also* Thomas A. Beaudoin et al., *Trends in the Private Equity Secondary Market*, 18 BUS. L. TODAY 4 (2009), http://www.abanet.org/buslaw/blt/2009-03-04/beaudoin.shtml (noting rise in secondary private market for private equity interests with increased need for cash and decreased distributions).

60. *See* Ribstein, *Partnership Governance of Large Firms*, *supra* note 1, at 304-05.

61. *See* Robert P. Bartlett III, *Going Private but Staying Public: Reexamining the Effect of Sarbanes-Oxley on Firms' Going-Private Decisions*, 76 U. CHI. L. REV. 7, 9-11 (2009) (showing that some large firms actually elected to go private with debt financing that was subject to Sarbanes-Oxley Act of 2002).

B. *Investment Banking*

Another potential category of publicly traded partnership under liberalized tax rules is firms that are both actively managed and lack reliable cash flows, and therefore seem inappropriate for uncorporate governance, but for which corporate governance is particularly costly. For example, there have been calls in the wake of the 2008-2009 financial meltdown to return investment banking firms to the partnership form they had prior to the 1990s.[62] These commentators argue that partnership-type joint and several liability, by focusing owners' attention on risks, would have avoided the improvident use of derivatives that brought down firms like Lehman Brothers and Bear Stearns. Owner liability, however, also could introduce the opposite problem of making managers excessively risk averse.

The modern uncorporation could offer a useful compromise for investment banks. These firms might become more like hedge funds, which survived the meltdown relatively well. Under this structure, managers would get high-powered owner-like compensation and owners could have cash-out rights similar to those of hedge fund limited partners, though perhaps subject to more constraints such as longer lock-in periods. Owner cash-out rights would force managers to maintain their credibility in capital markets rather than being able to rely on permanent capital subject only to occasional costly intervention by the market for control.

The biggest problem posed by uncorporate investment banking is that it could exacerbate concerns about market risk. Owner demands for cash might force distressed firms to sell assets in illiquid markets at "fire sale" prices. In the recent financial crisis, rapidly deteriorating asset values led to fears of investor runs on financial firms. Toppling financial firms reduce overall market liquidity and thereby can threaten the whole economy. Thus, rather than permitting the spread of the uncorporation into investment banking, regulators seem poised to apply increased regulation of the financial sector to uncorporations. Indeed, the U.S. House of Representatives passed a major financial reform bill that would, among other things, impose registration and systemic risk regulation on hedge funds,[63]

62. *See* James K. Glassman & William T. Nolan, *Bankers Need More Skin in the Game*, WALL ST. J., Feb. 25, 2009, at A15; Michael Lewis, *The End*, PORTFOLIO, Nov. 11, 2009, http://www.portfolio.com/news-markets/national-news/portfolio/2008/11/11/The-End-of-Wall-Streets-Boom?; Caroline Salas & Pierre Paulden, *Eat-What-You-Kill Bond Traders Rise From Wreckage*, BLOOMBERG.COM, Mar. 24, 2009, http://www.bloomberg.com/apps/news?pid=20601109&sid=aTfBlzAvaBoM&refer=news; *see also* Steven M. Davidoff, *A Partnership Solution for Investment Banks?*, N.Y. TIMES DEALBOOK, Aug. 20, 2008, http://dealbook.blogs.nytimes.com/2008/08/20/a-partnership-solution-for-investment-banks/ (noting that firm that best avoided problems with subprime—Goldman Sachs—"retain[ed] the most partnership-like attributes" of all investment banking firms, but that "all partnerships were not created equal").

63. *See* The Wall Street Report and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. (as passed by House of Representatives, Dec. 11, 2009). This follows Treasury's recommendation for hedge fund disclosure and registration contained in its white paper for financial regulatory reform. *See* U.S. DEP'T OF THE

while European regulators appear to be moving toward even tighter controls.[64]

It is important to keep in mind, however, that these market risks materialized in a financial industry dominated by corporations. Uncorporate governance could weed out the weakest firms before disaster strikes, thereby reducing the risk of a market-wide crisis of confidence. Uncorporations also can avoid some of the problems posed by bankruptcy of financial institutions. An uncorporation that cannot continue making distributions to its owners is in a different position from a firm that cannot continue paying its creditors in that it can deal with the potential shortfall by ex ante contract, possibly avoiding the need for a hasty ex post restructuring in bankruptcy.[65] This Article's analysis suggests that regulators should consider the basic governance differences between uncorporations and corporations when deciding which financial institutions are appropriate for systemic risk regulation.[66]

C. *Locking in Insiders*

The uncorporation could be useful for firms seeking outside equity investors but with assurances that managers will be able to exercise their discretion to promote certain objectives free from interference by purely profit-seeking investors. For example, media corporations such as the owners of *The Washington Post* and *The New York Times* have locked control in their founding families through dual class voting structures. Also, professional ethics rules in the United States currently prohibit law firms from having non-lawyer owners.[67] Competitive pressure could force both types of firms to seek new types of financing.[68]

TREASURY, FINANCIAL REGULATORY REFORM: A NEW FOUNDATION 37, http://www.financialstability.gov/docs/regs/FinalReport_web.pdf.

64. *See* Alistair MacDonald, *U.S. Enters Europe's Fund Debate*, WALL ST. J., July 27, 2009, at C3.

65. For a general analysis of contractual substitutes for bankruptcy, see Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311, 319-42 (1992).

66. Former Federal Reserve Chair Paul Volcker has argued that, even if some systemic risk regulation of the largest banking institutions is warranted, this regulation should not extend to hedge funds. *See* Paul A. Volcker, *Moral Hazard and the Crisis*, WALL ST. J., June 16, 2009, at A15 ("Hedge funds and private-equity funds have an entirely legitimate role to play in providing liquidity and innovation in our capital markets. I do not believe they need to be so closely supervised and regulated as depository institutions.").

67. *See* MODEL RULES OF PROF'L CONDUCT R. 5.4 (2007).

68. Indeed, Rupert Murdoch bought the formerly family-owned Dow Jones, publisher of THE WALL STREET JOURNAL, and an Australian law firm has had a successful public offering. As to the law firm public offering, see Slater & Gordon Ltd. Prospectus 8, 10–11 (April 13, 2007), http://www.slatergordon.com.au/docs/prospectus/Prospectus.pdf; *see also* Milton Regan, Bruce MacEwen & Larry E. Ribstein, *Law Firms, Ethics and Equity Capital: A Conversation*, 21 GEO. J. LEG. ETHICS 61 (2008).

Firms that need financing from passive investors might benefit from uncorporate governance. While a corporate dual-class voting structure accomplishes these firms' immediate objective of protecting the professional insiders' power, it entails potential agency costs, which may affect these firms' cost of capital. An uncorporate structure offers an alternative approach to protecting insiders' power by substituting incentive compensation and investor access to the cash for corporate-type monitoring by owners, judges, and independent directors.

VIII. CONCLUSION

This Article has shown that corporate and uncorporate firms have distinct functions. The uncorporation is most useful where agency costs can be constrained through high-powered incentive devices and by giving owners access to the firm's cash. On the other hand, some operating firms need the management flexibility that only the corporation can provide. The uncorporate domain, however, is likely to continue spreading because many types of firms can benefit from uncorporate approaches to addressing agency costs. In particular, even where the operating firm needs to be a corporation, uncorporate owners could provide the necessary discipline.

The use of uncorporations is likely to change with business conditions. Even slight shifts in background circumstances, such as regulations, tax rules, bankruptcy risk and cost, development and use of new types of financial instruments, financial market liquidity, and the need for capital lock-in, can affect firms' decisions to use corporate or uncorporate business forms.

Increased regulation of governance could reduce the use of the uncorporation. For example, lawmakers have been moving toward regulating hedge and private equity funds,[69] as well as toward mandating disclosure of ownership of all types of firms on the ground that these firms have been used to undermine enforcement of securities and other laws.[70] If firms have less to gain from the flexibility of the uncorporation they are more likely to seek the security of the corporate form.

The uncorporation may, however, be the antidote to increased regulation. The availability of a flexible alternative to the corporation, coupled with firms' ability to choose from among many jurisdictions' laws, powerfully constrains government's ability to regulate the governance of firms. Financial regulation potentially gives firms new opportunities to exploit the uncorporation's flexibility. This suggests that the uncorporation's domain is more likely to grow than to shrink over the long run.

69. *See supra* note 63 and accompanying text.

70. *See* Incorporation Tıansparency and Law Enforcement Assistance Act, S. 569, 111th Cong. (2009) (referred to S. Homeland Sec. and Gov't Affairs Comm., Nov. 5, 2009) (proposed Incorporation Transparency and Law Enforcement Assistance Act); NAT'L CONFERENCE OF COMM'RS ON UNIFORM STATE LAWS, UNIFORM LAW ENFORCEMENT ACCESS TO ENTITY INFORMATION ACT § 3 (Discussion Draft 2009).